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Perspective

OPEC: Awaiting the Market's Verdict

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The longest ministerial meeting in OPEC's history ended in London this week with the unprecedented decision to lower official oil prices by $5 per barrel. The most important points of the new agreement are:

- The official price of Arab Light, OPEC's benchmark crude oil, was lowered to $29 per barrel.
- An overall production ceiling of 17.5 million b/d was set as an average for the rest of the year.
- Individual production quotas were allocated to all members except Saudi Arabia, which will act as a "swing" producer to balance supply and demand.
- Price differentials established a year ago will be retained, except for Nigeria, which will be allowed to maintain an advantageous $1 price differential over the marker crude.

The oil ministers agreed that the new prices were to be considered as floors, and the individual country allocations as ceilings. Price discounting and the dumping of oil onto the spot market were also forbidden.

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The intense pressures on OPEC to adjust prices were the result of falling oil consumption and company efforts to reduce inventories. Free World oil consumption this winter fell about 6 percent below year-earlier levels as relatively warm weather—about 15 percent warmer than normal—pushed heating oil use about 1 million b/d below expected levels. As a result, oil companies were left with stocks well in excess of their needs and, combined with expectations of lower prices, caused a sizable inventory liquidation of about 4 million b/d in early 1983. Inventory liquidation and reduced consumption pushed demand for OPEC oil down to the 15 million b/d level in recent weeks. Market weakness was further intensified by reports of increased Soviet exports to Western Europe in recent months.

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Given current market conditions, OPEC's new overall ceiling is about 2.5 million b/d in excess of demand. Most of this is being absorbed by Saudi Arabia, whose current production is under 3 million b/d. Much uncertainty surrounds the willingness of certain members to observe the new ceilings and the apparent room for cheating in the agreement. Because the quotas are for production only, some members can still raise sales by exporting from stocks.

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Two members that ignored last year's quotas—Iran and Libya—are currently producing a combined 300,000 b/d above their assigned ceilings and their adherence to the new accord is in doubt. Venezuela, however, apparently has enough oil in storage to meet its export goals for the year while producing within the new ceiling. At the same time, members facing serious revenue problems, such as Nigeria and Indonesia, are producing a combined 500,000 b/d below their quotas and would like to produce more. [redacted] 25X1

Nigeria will come under severe pressure to cut prices again if sales fail to increase or if North Sea producers adjust prices downward as several market observers expect. Lagos has already threatened to match any North Sea price cut. Price cuts by other non-OPEC producers would also add downward pressure and fuel market expectations of a downward price spiral. Mexico lowered its prices $2 to $3.50 per barrel following the OPEC meeting, and the Soviet Union can be expected to remain competitive to ensure hard currency sales. [redacted] 25X1

The main near-term factors heavily influencing the fate of the agreement are market psychology and Saudi willingness to bear the brunt of the likely downard pressure on demand. Both these factors pose considerable uncertainties:

- Most observers believe the agreement lacks credibility under present market conditions. If this attitude continues, as seems likely for at least a few weeks, companies will continue to unload stocks and keep OPEC production well below 17.5 million b/d.
- The Saudis achieved the price cut they apparently have desired for several months, and Riyadh's willingness to play the role of swing producer may underpin the agreement. Saudi output, however, is already below 3 million b/d and they may have little room or desire to go much lower. [redacted] 25X1

Should the agreement survive the coming weeks of non-OPEC price cuts and destocking, the key to further success will rest with a rebound in consumption. There are no signs yet that the decline in oil use has bottomed out, and there is little hope that it will until a sustained economic recovery gets under way in OECD countries. [redacted] 25X1

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